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RR RUEHCHI RUEHDT RUEHHM
DE RUEHJA #6648/01 1460826
ZNR UUUUU ZZH
R 260826Z MAY 06
FM AMEMBASSY JAKARTA
TO RUEHC/SECSTATE WASHDC 4821
RHMFIUU/DEPT OF ENERGY WASHINGTON DC
RUCPDOC/DEPT OF COMMERCE WASHDC
INFO RUEHZS/ASSOCIATION OF SOUTHEAST ASIAN NATIONS
RUEHKO/AMEMBASSY TOKYO 9811
RUEHBY/AMEMBASSY CANBERRA 9507
RUEHBJ/AMEMBASSY BEIJING 3447

UNCLAS SECTION 01 OF 04 JAKARTA 006648

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DEPT FOR EAP/MTS AND EB/ESC/IEC
DEPT PASS OPIC, EXIM, TDA
DOE FOR CUTLER/PI-32 AND NAKANO/PI-42
COMMERCE FOR USDOC 4430

E.O. 12958: N/A
TAGS: EPET ENRG EINV PREL ID
SUBJECT: INDONESIA COPES WITH HIGH OIL PRICES

¶1. (SBU) Summary. The Government of Indonesia's (GOI) October 2005 decision to slash fuel subsidies has better positioned Indonesia's economy to withstand the macroeconomic pressures from sustained high global fuel prices. Domestic fuel consumption, and very likely illegal smuggling of subsidized fuel, has fallen substantially since October 2005. These changes were sufficient to return Indonesia to net oil exporter status by the fourth quarter of 2005. Indonesia now benefits, if just slightly, from global oil prices in the USD 60-70 per barrel (bbl) range. Nonetheless, Ministry of Finance (MOF) budget simulations predict the FY 2006 budget deficit will swell from 0.7 to about 1.3 percent of GDP if oil prices remain at or below USD 70/bbl due to higher than expected domestic interest rates, lower than expected oil production, and an increase in subsidy spending. Should international oil prices rise significantly above USD 70/bbl for an extended period of time, the resulting gap between Indonesia's domestic fuel prices and prices in neighboring countries could reignite large-scale fuel smuggling and put additional pressure on the budget. Although international oil prices have far exceeded the USD 57/bbl level specified in the budget for much of 2006, we see no signs the Yudhoyono Administration is contemplating another fuel subsidy cut in 2006. This cable uses an exchange rate of Rp. 9180 = 1 USD. End summary.

October 2005 Fuel Price Hikes Provide Cushion

¶2. (U) On October 1, 2005 the GOI hiked subsidized fuel prices by an average 126 percent. In the third quarter of 2005 before raising prices, Asia's only OPEC member had fallen into net-importer status (as measured by volume) due to almost a decade of declining production and steadily increasing domestic demand as the country recovered from the 1997-98 financial crisis. Since that bold decision, Indonesia has seen domestic fuel consumption, and very likely illegal smuggling, of subsidized fuel fall. The electric power industry has also begun to diversify away from fuel oil for power generation toward increased use of coal and natural gas. These changes were sufficient to return Indonesia once again to net exporter status on a volume basis by the fourth quarter of 2005. On a dollar-value basis Indonesia is still a net importer, but the deficit has shrunk dramatically (see tables 1 and 2).

¶3. (SBU) Petroleum imports fell from a high of 19 million

bbl in August 2005 to just 11.7 million bbl in November 2005, a drop of 38 percent. Domestic fuel consumption fell 23 percent during that same time period. One likely explanation for the significant disparity between the magnitude of the declines in fuel imports and consumption is that fuel smuggling accounted for much of the difference. By our calculations, at its highest point smuggling may have amounted to as much as 2.9 million bbl/month at a monthly cost of USD 165 million under the GOI budgetary assumption of USD 57/bbl of oil.

¶4. (SBU) The dollar value of petroleum imports has also fallen significantly on a month-to-month basis. August 2005 saw a record import bill of USD 2 billion, which fell to USD 1 billion by January 2006. Net imports have averaged only USD 273 million during the first three months of 2006, 59 percent below the monthly average for the same period in 2005 and about five percent below 2004 figures, when international oil prices averaged USD 36/bbl.

Table 1: Monthly Trade of Crude Oil and Refined Products

(Volume in 1,000 barrels, Value in USD million)

Month	Exports Volume	Exports Value	Imports Volume	Imports Value
2004 avg	20,322	684	25,300	970
2005 avg	15,595	770	13,882	902
Aug. 2005	14,272	916	19,018	2,031

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Month	Exports Volume	Exports Value	Imports Volume	Imports Value
Sep. 2005	14,542	923	17,390	1,773
Oct. 2005	14,261	913	15,010	1,528
Nov. 2005	15,161	826	11,700	1,222
Dec. 2005	17,955	967	13,878	1,305
Jan. 2006	-	951	-	1,084
Feb. 2006	-	831	-	1,207
Mar. 2006	-	900	-	1,211

Source: Bank Indonesia (BI), Directorate General of Oil and Gas (MIGAS), and Central Bureau of Statistics (BPS)

Table 2: Net Petroleum Exports

(Volume in 1,000 barrels, Value in USD million)

Month	Net Exports Volume	Net Exports Value
2004 avg	(2,394)	(287)
2005 avg	1,713	(132)
Aug. 2005	(4,746)	(1,115)
Sep. 2005	(2,848)	(850)
Oct. 2005	(749)	(616)
Nov. 2005	3,461	(395)
Dec. 2005	4,077	(339)
Jan. 2006	-	(132)
Feb. 2006	-	(376)
Mar. 2006	-	(311)

Source: BI, MIGAS, and BPS

Indonesians Still Get Bargain Gas

¶5. (U) Even after the October 2005 price hikes, Indonesian consumers still enjoy significantly lower prices at the pump

compared with most of their neighbors (Table 3). Indonesians currently pay the equivalent of USD 1.93 per gallon for unleaded gasoline, compared with USD 4.13 per gallon in Singapore and USD 2.90 in the U.S.

Table 3: Retail Petrol Prices

(Prices per liter in USD as of April 28, 2006.)

Country	Unleaded Gas	Diesel
Indonesia	0.51	0.49
Philippines	0.75	0.67
Singapore	1.08	0.87
Thailand	0.74	0.69
Malaysia	0.53	0.44

Sources: BI, Pertamina, ExxonMobil

High Oil Prices: Slightly Positive for Budget

¶6. (SBU) Government expenditures for subsidized fuel are creeping up once again as Indonesia and the world grapple with sustained high price levels for oil. For now, however, increased oil revenues still more than match the increased outlays. With crude oil prices topping USD 70/bbl, the MOF projects fuel subsidy spending will increase to Rp 68.3 trillion (USD 7.44 billion) in 2006, an increase of Rp 14 trillion (USD 1.53 billion) over budgeted figures. However, the Ministry of Finance (MOF) believes high oil prices have a slightly positive effect on the budget, though they caution the relationship is not linear. They estimate the size of the net gain at Rp 200 billion or USD 22 million (plus or minus a variance of Rp 0.1 trillion or USD 11 million) per every one-dollar increase in the international oil price.

¶7. (SBU) According to the MOF, Indonesia gains Rp 3.6 trillion (USD 392 million) from each one-dollar increase in international oil prices in tax and non-tax (royalty) revenues. At the same time, budget expenditures rise by Rp 3.4 trillion (USD 370 million), broken down as follows:

--Rp 2.3 trillion (USD 251 million) for increased fuel subsidy costs;
--Rp 0.6 trillion (USD 65 million) for revenue sharing with the provincial and local governments;
--Rp 0.6 trillion for increased electricity subsidies necessary to compensate state electricity company PLN for the higher cost of diesel for power generation.

Under MOF projections of sustained global prices at USD 60, 65 or 70/bbl, MOF believes it can maintain the budget deficit at an easily manageable 1.3 percent of GDP level.

¶8. (SBU) The MOF's projection rests heavily on Pertamina's willingness and ability to pay approximately Rp 16 trillion (USD 1.74 billion) in non-tax oil and gas revenues from 2005 currently in arrears. Pertamina has also not forwarded an undetermined amount of its 2005 tax obligations to the GOI, according to a MOF tax official. (Note: Two can play this game. The MOF has also not reimbursed Pertamina for an estimated Rp 15 trillion, or USD 1.63 billion, in subsidy payments due in the first quarter of 2006.) The World Bank and private sector analysts do not anticipate any large negative impact on reserves or the rupiah from current fuel prices. The Indonesia IMF office estimates informally that while current global fuel prices are fairly budget neutral, if they rise to USD 80/bbl or more for a sustained period, the impact on Indonesia's budget would start to turn negative (assuming no change in subsidy policy).

Resumed Smuggling a Risk

¶9. (SBU) Should the gap between Indonesia's domestic fuel prices and those of its neighbors grow large enough, increasing oil prices have the potential to rekindle oil smuggling, which could force the MOF to revisit its current budget scenario. The wholesale gasoline price in Indonesia is now USD 1.68 per gallon, whereas the spot price in Singapore was USD 2.16 per gallon on May 5, offering only a maximum 29 percent potential profit margin to would-be smugglers. In August 2005, a period of likely high levels of smuggling, the gap between wholesale prices in Singapore and Indonesia was 48 percent. An additional concern is the possibility for rising internal smuggling--since July 2005, Pertamina has sold diesel and gasoline to industrial users at market rates, currently an average of 25 percent above the subsidized prices at the company's retail gas stations. There are already indications that sales of diesel to industry are falling rapidly at the same time that sales of subsidized diesel have risen back to their pre-price hike levels. The GOI decision in early May to permit large fishing vessels (over 30 gross tons) to have increased access to subsidized fuel makes international smuggling all the more easy, which in turn has the potential to put some additional pressure on the budget.

INDONESIA'S FUTURE WITH HIGH PRICED OIL

¶10. (SBU) Despite some risks, Indonesia is much better positioned to ride out the current sustained high world oil prices than it was during the first shock in August 2005, which led to a sharp rupiah sell-off. Private and public sector economists agree that Indonesia will likely begin to experience difficulties if world oil prices reach USD 80/bbl or higher for sustained periods of time. At current levels of consumption, however, it would take a world price of USD 92/bbl before Indonesia faces the same fiscal drain as it did before the October 2005 decision to cut back fuel subsidies, according to a well-respected Singapore-based economist. (Note: This estimate does not account for possibly large increases in fuel smuggling at that price level.)

¶11. (SBU) The GOI is continuing to look for ways to cut

fuel use even further than present levels, though none show much promise. State Minister for National Development Planning and National Development Planning Board chairman Paskah Suzetta proposed limiting fuel use by private and state vehicles, based on engine sizes, presumably to penalize wealthy SUV drivers. Other political figures have proposed restricting cars from using the roads certain days of the week based on odd or even license tag numbers.

Comment

¶12. (SBU) GOI economic officials uniformly tell us that President Yudhoyono has ruled out any increase in the price of subsidized fuels or electricity tariffs until at least 2007 even with the sustained high levels of world petroleum prices. Nonetheless, the GOI will likely use the upcoming July budget revision to begin the delicate process of socializing the Indonesian public to the continuing high cost of subsidized fuel, even with the bitter pill of the October 2005 cuts still fresh in the public's mind. Should further increases in international oil prices force the GOI to look seriously at another price hike, we expect the GOI to seek to obtain formal Parliamentary approval via the FY 2007 budget process, which will commence in August 2006. Given current economic conditions in Indonesia, this would likely be a very tough sell.